COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF KENTUCKY POWER COMPANY d/b/a AMERICAN ELECTRIC POWER TO ASSESS A SURCHARGE UNDER KRS 278.183 TO RECOVER COSTS OF COMPLIANCE WITH THE CLEAN AIR ACT AND THOSE ENVIRONMENTAL REQUIREMENTS WHICH APPLY TO COAL COMBUSTION WASTE AND BY-PRODUCTS	)))))))	CASE NO. 96-489

O R D E R

On July 8, 1997, the Commission granted rehearing on the issue of including short-term debt in the capital structure for Kentucky Power Company, d/b/a American Electric Power ("Kentucky Power"). Kentucky Power was ordered to provide the balances for short-term debt, long-term debt, and common equity as well as the calculations showing the determination of the blended interest rates for short-term and long-term debt as of December 31, 1996. Any request for a hearing on the determination of the amount and cost of Kentucky Power's short-term debt was to be filed within 15 days of the July 8, 1997 Order.

Kentucky Power filed the requested information on July 16, 1997 and no party has requested a hearing on this issue. The information indicates that Kentucky Power's

weighted average cost of capital as of December 31, 1996 was 9.215 percent.[1] After adjusting the common equity weighted average cost of capital component for income tax gross-up, the overall weighted average cost of capital is 12.45 percent.[2]

In its May 27, 1997 Order, the Commission established Kentucky Power's weighted average cost of capital to be 9.412 percent based on a capital structure that included only long-term debt and common equity as of December 31, 1996. As noted in the July 8, 1997 Order, detailed information on Kentucky Power's short-term debt as of December 31, 1996[3] was not then in the record. That information having now been provided, the Commission finds it appropriate to include short-term debt as a component of Kentucky Power's capital structure. This results in a weighted cost of capital of 9.215 percent which should be used for all environmental surcharge filings subsequent to the date of this Order.

Also pending is Kentucky Power's motion for the Commission to clarify its prior Orders to provide explicitly that any difference between the surcharge amount collected

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1 The Weighted Average Cost of Capital, before income tax gross-up, is determined as follows:

	Capital Structure	Cost	Weighted Cost
Long-Term Debt	49.85%	7.844%	3.910%
Short-Term Debt	8.79%	6.248%	.549%
Common Equity	41.36%	11.500%	4.756%
Weighted Average Cost of Capital			9.215%

2 Response to the Commission's July 8, 1997 Order, page 1 of 3.

3 Case No. 96-489, July 8, 1997 Order, at 11.

or refunded and the amount ultimately allowed can be recovered, with interest, through the surcharge should it ultimately be determined that Kentucky Power is entitled to more cost recovery than it has collected.

Traditionally, when the Commission modifies a rate order on rehearing, the modification operates prospectively only since an implementation back to the original rate order would constitute impermissible retroactive rate-making. See Western Kentucky Gas Co. v. Public Service Commission of Kentucky, et al., Ky.App., No. 93-CA-001600-MR (Slip Opinion dated December 2, 1994) (Copy attached hereto as Appendix A.) The only exception to this cardinal rule of rate-making is when the modification is limited to correcting mathematical or clerical errors, since in such cases an implementation back merely effectuates the Commission's originally expressed intent. See Kentucky Power Co. v. Energy Regulatory Commission, Ky., 623 4S.W.2d 904 (1981), and Mike Little Gas Co. v. Public Service Commission, Ky.App., 574 S.W.2d 926 (1978).

Based on these precedents, the modification approved herein to reflect short-term debt in Kentucky Power's capital structure will operate prospectively only since the May 27, 1997 Order did not specify the inclusion of short-term debt. In the event the Commission's Orders are vacated in whole or in part by a court and remanded to the Commission for subsequent modification, whether such modification operates prospectively or retroactively will depend on the nature and scope of the court's remand and the established legal precedents. Thus, the Commission finds no basis to modify its prior Orders to provide that any subsequent modification will be implemented retroactively as Kentucky Power now requests.

IT IS THEREFORE ORDERED that:

1. Kentucky Power shall use a weighted average cost of capital of 9.215 percent in all monthly environmental surcharge filings subsequent to the date of this Order.

2. All other provisions and requirements set forth in the Commission's May 27, 1997 Order shall remain in full force and effect.

3. Kentucky Power's motion for clarification of prior Orders to provide that any subsequent modifications will be implemented retroactively is denied.

Done at Frankfort, Kentucky, this 18th day of August, 1997.

PUBLIC SERVICE COMMISSION

Linda K Breathitt
Chairman

Vice Chairman

B. J. Helton
Commissioner

ATTEST:

Don Mills
Executive Director

APPENDIX A

AN APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 96-489 DATED AUGUST 18, 1997

RENDERED: DECEMBER 2, 1994; 2:00 p.m.
NOT TO BE PUBLISHED

Commonwealth Of Kentucky

Court Of Appeals

NO. 93-CA-001600-MR

WESTERN KENTUCKY GAS COMPANY — APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE WILLIAM L. GRAHAM, JUDGE
ACTION NO. 91-CI-000874

PUBLIC SERVICE COMMISSION OF KENTUCKY;
ATTORNEY GENERAL OF KENTUCKY;
KENTUCKY INDUSTRIAL UTILITY CUSTOMERS;
MARTHA SUE HOLMES;
WESTERN KENTUCKY LEGAL SERVICES;
LOGAN ALUMINUM, INC. AND
EVERETT N. BRAWNER — APPELLEE

OPINION
AFFIRMING

* * *

BEFORE: DYCHE, JOHNSON, AND SCHRODER, JUDGES.

SCHRODER, JUDGE: This is an appeal from a judgment of the Franklin Circuit Court affirming an order of the Kentucky Public Service Commission regarding rates and charges for services to be charged by appellant. After reviewing appellant's arguments, the record herein, and the applicable law, we likewise affirm.

Kentucky Gas Company ("Western") was acquired by another corporation, Atmos Energy ("Atmos"), in 1987. The transfer was structured such that the existing deferred tax balance on the books of Western was zeroed out or eliminated. On February 13, 1990, Western filed proposed rate schedules with the Public Service Commission of Kentucky (the "Commission") seeking an 8% increase in revenue (an $8.9 million increase). Under KRS 178.180, Western proposed to make the new rates effective on March 15, 1990. Pursuant to KRS 278.190, the Commission suspended implementation of the proposed rate increases for five months thereafter.

Following exhaustive discovery by the Commission, the Commission held a public hearing on Western's proposed rates on June 20-22 and June 27-28, 1990. On September 13, 1990, the Commission entered an order increasing Western's annual revenues approximately $1.0 million. The main reason Western's full requested rate increase ($8.9 million) was denied was because the Commission utilized a deferred income tax adjustment, which attempted to re-create the balance eliminated when Atmos acquired Western.

When rates are set by the Commission, the amount of a utility's deferred taxes is either deducted from the amount of property dedicated to utility service (rate base) or included as an item of capital with no cost. The effect is to reduce the level of income which the utility would otherwise be permitted to earn by reducing the amount of property upon which the return is earned. In other words, if the Commission did not utilize the deferred

income tax adjustment, the utility would be allowed to charge a higher rate, whereas if the Commission did apply the deferred income tax adjustment, it would result in a lower rate to be charged. In arriving at its order of September 13, 1990, the Commission did apply the deferred income tax adjustment by effectively reconstructing the asset, and subsequently applied a lower rate.

Thereafter, pursuant to KRS 278.400, Western requested and was granted a rehearing. After a second public hearing, which considered new evidence, the Commission entered its rehearing order on May 29, 1991, in which it decided not to utilize the deferred tax adjustment and, thus, increased Western's rates by an additional $2.6 million in annual revenues. In so doing, the Commission stated:

> The Commission has determined that the findings contained in the original Order with regard to the rate-making treatment of the transfer-related deferred tax losses are valid, theoretically sound, and would fairly reflect and account for the sources of funds used for investment in utility assets if not for the rulings of the Internal Revenue Service. The uncontested testimony in the rehearing reflects that if the Commission applies this rate-making treatment in this instance, the utility will be subject to rulings of the Internal Revenue Service which would preclude it from utilizing accelerated depreciation for tax purposes. Accelerated depreciation provides, through the normalization process in rate-making, funds from capital investment. The risk of loss of such tax benefits would not be in the best interests of the utility or the ratepayers. Due to the violation of normalization requirements, the Commission finds it appropriate to remove the adjustment for Transfer Related Deferred Tax Losses.

Western had also requested on rehearing a remedial surcharge to recover the lost revenue in the event the Commission reversed its prior ruling and granted a greater increase. The Commission denied Western's request on grounds that it would constitute "retroactive ratemaking".

Western thereafter appealed to the Franklin Circuit Court, which affirmed the Commission's Rehearing Order. From that judgment, Western now appeals.

Western first argues that its constitutional due process rights were violated when the Commission applied the "surprise" deferred income tax adjustment in its original order without giving reasonable advance notice to Western that such an adjustment was under consideration at the time of the first public hearing. Western maintains that because it did not have notice that the Commission was contemplating utilizing the deferred income tax adjustment (which it had never utilized before), it was unconstitutionally precluded at the hearing from presenting evidence to prove the impropriety of such an adjustment.

First, as the circuit court pointed out, Western should not have been surprised by the application of the deferred income tax adjustment, because it appears from the record that both the Commission and the Attorney General made various data requests of Western regarding its deferred taxes and, in particular, its deferred investment tax credit. This inquiry was all due to Atmos's structuring the purchase of Western so as to eliminate the existing deferred tax balance on its books. Secondly, in our view,

the Commission was not obliged to inform Western at the initial hearing what its decision would be and how it would arrive at such decision. The Commission should not be required to know at the time of the hearing how it would rule and why. That is the purpose of the hearing. Lastly, the only new evidence presented by Western at the second hearing was regarding the tax consequences and policy consideration of utilizing the deferred income tax adjustment. On rehearing, the Commission simply took the same financial evidence it had before it in the first hearing and decided for policy reasons not to utilize the deferred income tax adjustment, not because it erred in using such an adjustment.

Western next argues that the Commission violated KRS 278.190(3) in not issuing a ruling within ten months after the filing for a rate increase, since the first order was allegedly unconstitutional and the order on rehearing was not entered until some fifteen months after such filing. We believe this argument to be without merit. KRS 278.190(3) states as follows:

> At any hearing involving the rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the utility and the commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible, and in any event not later than ten (10) months after the filing of such schedules.

Notwithstanding that the Commission later reversed its original order, the Commission in good faith entered this first order (which was constitutional) within seven months of Western's filing. The separate statute controlling rehearings, KRS 278.400, states that

applications for rehearing must be filed within twenty days of the Commission's order, and the Commission shall grant or deny the rehearing request within twenty days after the application for rehearing has been filed or the application is considered denied. Neither statute provides or implies that rehearing orders must also be entered within ten months of the filing of the rate increase and such an interpretation of these statutes would be absurd.

Western's third and fourth arguments will be considered together. Western argues that the Commission erred in refusing to grant it a remedial surcharge for the revenue lost between the time of the original order and the rehearing order. The Commission and the circuit court both found that a remedial surcharge could not be permitted as it would constitute "retroactive ratemaking." KRS 278.180(1) provides as follows:

> Except as provided in subsection (2) of this section, no change shall be made by any utility in any rate except upon thirty (30) days' notice to the commission, stating plainly the changes proposed to be made and the time when the changed rates will go into effect. However, the commission may, in its discretion, based upon a showing of good cause in any case, shorten the notice period from thirty (30) days to a period of not less than twenty (20) days. The commission may order a rate change only after giving an identical notice to the utility. The commission may order the utility to give notice of its proposed rate increase to that utility's customers in the manner set forth in its regulations.

KRS 278.270 states:

> Whenever the commission, upon its own motion or upon complaint as provided in KRS 278.260, and after a hearing had upon reasonable notice, finds that any rate is unjust,

> unreasonable, insufficient, unjustly discriminatory or otherwise in violation of any of the provisions of this chapter, the commission shall by order prescribe a just and reasonable rate to be followed in the future.

From our reading of the above statutes, we agree that the Commission can only set rates prospectively. KRS 278.190 is the only statute that allows for any retroactive action in that it requires a utility to refund any increased charges during the pendency of a requested rate increase if the Commission later disallows the increase in its order.[1] There is no allowance in the statute for the converse of that situation.

Western cites to two cases which it claims authorize a remedial surcharge in this case. In Kentucky Power Co. v. Energy Regulatory Commission of Kentucky, Ky., 623 S.W.2d 904 (1981), the Commission found that the utility was entitled to earn an additional $7.0 million in revenues. However, the rates which were set by the Commission would produce only $3.5 million in increased revenues. In that case, the circuit court ordered that the Commission set rates that would produce $7.0 million in revenues and further allowed a remedial surcharge to enable the utility to recoup its losses from the time of the order. We believe the case at bar is distinguishable from Kentucky Power Co., supra, in that

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[1]It should further be noted that KRS 278.190(2) provides that if the Commission has not issued an Order determining the fair, just, and reasonable rates for a utility at the expiration of the five month suspension period, the utility has the legal right to put its proposed rates into effect, subject to refund. In the instant case, Western was entitled to put its proposed rates into effect, subject to refund on August 15, 1990. Western chose not to put its rates into effect on that date even though it had the legal right to do so.

there was no such inconsistency or error in the Commission's original order in the present case. In that order, the Commission found that Western was entitled to earn an additional $1.0 million in revenues and set rates which would produce $1.0 million in additional revenues. In the instant case, the Commission reversed itself for policy reasons only after Western presented new evidence of tax consequences on rehearing. Only then did the Commission find that Western was entitled to earn an additional $2.6 million in revenues.

Even more distinguishable is the case of Mike Little Gas Co., Inc. v. Public Service Commission of Kentucky, Ky. App., 574 S.W.2d 926 (1978), wherein the Court held that the Commission could correct an obvious clerical error in its order and give it retroactive effect. In the present case, the Commission did not make an obvious clerical error. Further, the error in Mike Little Gas Co., supra, was in the utility's favor and, thus, the retroactive effect of the correction was that the ratepayers were entitled to a refund, which, as stated previously, has been authorized by statute.

In sum, we agree with the lower court that the requested remedial surcharge would constitute retroactive ratemaking and, thus, could not be permitted.

For the reasons stated above, the judgment of the Franklin Circuit Court is affirmed.

ALL CONCUR.

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